APPENDICES

APPENDIX A: THE CORPORATE INCOME TAX IN THE UNITED STATES

A.1 BRIEF DESCRIPTION OF THE CORPORATE INCOME TAX

The corporate income tax originally was enacted in 1909 as an excise tax on the privilege of doing business in the corporate form. An individual income tax on dividend income was enacted in 1916.

The Corporate Income Tax Base

Corporations are generally taxed at a 34 percent marginal rate on their taxable income. To compute taxable income, a corporation deducts from gross income business expenses paid or incurred during the taxable year. These expenses include employee compensation, state and local taxes, depreciation, and interest expense, but not dividends paid. When deductions exceed income, a corporation has a net operating loss (NOL). Corporations generally can carry back net operating losses to offset taxable income for the 3 preceding years and can carry forward any remaining net operating loss to offset taxable income for 15 years.

Like individuals, corporations generally include gains on appreciated assets in income (and deduct losses on depreciated assets from income) only when the assets are sold or otherwise disposed of (when the gains or losses are realized). Corporations may deduct capital losses only against capital gains, and unused capital losses may be carried back for 3 years and forward for 5 years.

Because the double tax on corporate earnings distributed to shareholders might become a triple or quadruple tax if corporations were taxed in full on dividends received from other corporations, a corporate shareholder is entitled to a full or partial dividends received deduction (DRD), depending on its percentage ownership of the distributing corporation.

U.S. corporations are subject to tax on foreign as well as domestic income. Although a U.S. corporation is required to pay U.S. tax currently on foreign income earned through a foreign branch, U.S. tax is generally not imposed on earnings of a foreign subsidiary until the subsidiary distributes its income to the parent corporation as a dividend. In computing U.S. tax liability, U.S. taxpayers (including corporations) are allowed a credit for foreign taxes paid, subject to certain restrictions. See Chapter 7.

In addition to these general rules, special rules apply to specific types of businesses that conduct activity in corporate form, such as financial institutions and insurance companies. Other special rules apply to specific types of activities, such as the exploration, development, and production of natural resources. Certain types of corporations are granted full or partial relief from corporate level tax.

Tax Rates

Corporations are subject to tax at a rate of 15 percent on the first $50,000 of taxable income, 25 percent on the next $25,000 of taxable income, and 34 percent on taxable income above $75,000. The marginal rate on a corporation's taxable income between $100,000 and $335,000 is increased by 5 percent to phase out the benefit of the graduated rate structure. Thus, corporations with incomes in the phaseout range pay tax at a marginal rate of 39 percent. Corporations with taxable incomes in excess of $335,000 pay tax at a flat 34 percent rate. In 1989, over 90 percent of corporate taxable income was taxed at the 34 percent rate.

Corporations also are subject to an alternative minimum tax (AMT). Corporations pay AMT only if their minimum tax liability exceeds their regular tax liability. A corporation's AMT base is its taxable income, adjusted to eliminate the benefit of certain deferrals of income, accelerations of deductions, and permanent exclusions. The resulting amount, alternative minimum taxable income (AMTI), is reduced by an exemption amount and is taxed at a 20 percent rate. The basic exemption amount is $40,000, which is reduced by 25 percent of the amount by which AMTI exceeds $150,000. A corporation's minimum tax liability can generally be credited against future regular tax liability.

Entities Subject to the Corporate Tax

A business entity is taxable as a corporation if it is organized as a corporation under state law. In addition, Treasury Regulations treat an unincorporated entity as a corporation if it has more corporate characteristics than noncorporate characteristics. The four relevant corporate characteristics are: (1) continuity of life, (2) centralization of management, (3) limitation of liability for debts to property of the entity, and (4) free transferability of interests.[1] Certain partnerships also are treated as corporations if their interests are traded on an established securities market or are readily tradable on a secondary market (or its equivalent) and the partnership is not engaged in a qualifying passive activity.[2]

Subchapter C refers to the provisions of the Code that apply to most corporations. In 1958, Congress enacted Subchapter S of the Code to enable certain corporations to elect exemption from the corporate level tax. S corporations, like partnerships, are generally treated like conduits for tax purposes. The income of S corporations is taxed directly to their shareholders. To qualify for this passthrough treatment, a corporation must have no more than 35 shareholders and only one class of stock, and all of its shareholders must be individuals who are U.S. citizens or residents or certain trusts and estates. There also are restrictions on an S corporation's affiliations with other corporations.

In addition to S corporations, other entities that meet certain restrictions on assets, type of business, and distributions to shareholders qualify as conduits for all or a portion of their income. A regulated investment company (RIC), a mutual fund that makes diversified investments for its shareholders, pays no tax on amounts distributed to its shareholders if it distributes currently at least 90 percent of its dividend and interest income and meets certain other conditions.[3] A real estate investment trust (REIT), a corporation or association that specializes in investments in real estate and real estate mortgages, also may receive passthrough treatment if it meets certain conditions designed to ensure that its assets and income are primarily related to real estate.[4] A real estate mortgage investment conduit (REMIC), an entity that holds a fixed pool of mortgages and issues multiple classes of interests to investors, also qualifies for passthrough treatment.[5] Qualified distributions to members of cooperative organizations also are taxed directly to the members and are not taxed at the entity level.

Treatment of Debt and Equity

Under present law, the tax treatment of the returns to an investor in a corporation depends upon whether an investment is considered debt or equity. A corporation generally can deduct interest on corporate debt.[6] Consequently, corporate earnings paid to debtholders as interest bear no tax at the corporate level. In contrast, because dividends are not deductible, corporate tax must be paid on the earnings attributable to equity investments, regardless of whether the earnings are retained or distributed.

Individual debtholders are taxed on interest income when received or accrued, in accordance with their method of accounting. Individuals are taxed on corporate income when the income is distributed to them as dividends.[7] Increases in the value of corporate stock held by individuals, whether due to retained earnings, appreciation of the corporation's assets, or other factors, are generally not taxed until the stock is sold.[8] Such gains are generally capital gains. Individuals also may not deduct losses on corporate stock until the stock is sold. Such losses are generally capital losses and may be deducted without limitation against capital gains. However, capital losses in excess of capital gains also may be used to offset only $3,000 of an individual's ordinary income per year, with any excess carried forward indefinitely.

Corporate debtholders also pay tax on interest income when received or accrued, in accordance with their method of accounting. A corporate shareholder must include all dividends in income but can deduct a portion of dividends received from other domestic corporations. The deduction for dividends received is 70 percent if the recipient corporation owns less than 20 percent of the stock of the payor, and 80 percent if the recipient corporation owns between 20 percent and 80 percent of the stock of the payor.[9] Intercorporate dividends among members of affiliated groups (each 80 percent or more owned, directly or indirectly, by a common parent) are generally fully deductible by the recipient. Thus, the maximum rate of tax on dividends received by corporate shareholders is generally 10.2 percent (30 percent of dividends received multiplied by the 34 percent corporate tax rate). Corporate capital gains are currently taxed at the same rate as ordinary income, and capital losses may offset capital gains, but not ordinary income, with a 3 year carryback and 5 year carryforward.

Although debt and equity are treated very differently by the tax system, distinguishing debt from equity is not straightforward. In 1969, Congress authorized the Department of the Treasury to issue regulations to determine whether an interest in a corporation should be treated as stock or debt for tax purposes. Congress suggested that Treasury consider the following factors in making this determination: (1) the existence of a written unconditional promise to pay on demand or on a specified date a sum certain in money at a fixed rate of interest, (2) whether the instrument is subordinated to or has preference over any debt of the corporation, (3) the issuer's debt to equity ratio, (4) whether the instrument is convertible into stock, and (5) the relationship between holdings of the issuer's stock and holdings of the instrument in question.[10]

Although Treasury issued three drafts of regulations attempting to distinguish debt from equity, the task of devising simple, workable rules for distinguishing between debt and equity proved elusive. Ultimately, Treasury withdrew all of these regulations.

In the absence of regulations, taxpayers and the IRS look to judicial opinions and IRS rulings to determine whether an instrument will be treated as debt or equity for tax purposes. In addition to the factors listed in the 1969 statute, the following factors have been considered relevant: (1) the holder's rights upon default, (2) the equity features of the instrument, such as voting rights or participation in earnings, (3) whether the corporation has sufficient projected cash flow to service the debt, (4) whether the holder has management rights, and (5) whether the holder acts like a reasonable creditor in protecting its rights.

To summarize, it has not proved possible to develop simple and acceptable guidelines for distinguishing between debt and equity. As financial markets become more flexible and innovative, that task becomes more difficult. The administrative complexity and compliance costs associated with making the debt-equity distinction are serious problems in the current system of corporate taxation.

Cross-Border Investment

The tax treatment of cross-border investment is discussed in Chapter 7.

Tax-Exempt Organizations

The treatment of tax-exempt organizations is discussed in Chapter 6.

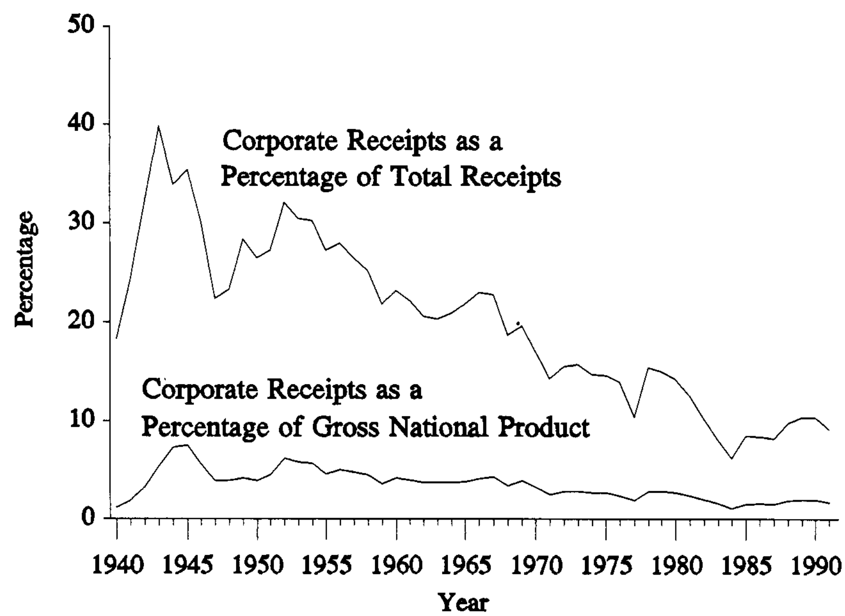
A.2 OVERVIEW OF U.S. CORPORATE TAX RECEIPTS

In 1990, the corporate tax generated Federal revenues of $93.5 billion. Federal corporate tax receipts have generally increased over the past 40 years, but when adjusted for inflation, they have fallen since the late 1960s. In constant 1982 dollars, corporate tax receipts averaged $85 billion per year in the 1950s, $86 billion per year in the 1960s, $77 billion per year in the 1970s, and $56 billion per year from 1980 to 1986. Since 1986, real corporate tax receipts have averaged $76 billion per year in 1982 dollars. From the 1950s to 1986, corporate receipts also fell as a percentage of Federal budget receipts and of gross national product (GNP). See Figure A.1. Since 1986, however, the decline in the relative importance of the corporate tax has stopped and may have reversed. From 1987 through 1990, corporate receipts averaged 9.9 percent of total Federal budget receipts, above the average of 8.9 percent for the rest of the 1980s, but less than the 1970s average of 15.0 percent. From 1987 to 1990, estimated tax liabilities for nonfinancial corporations, relative to GNP or gross domestic product, also slightly exceeded the average for the early 1980s.

The Tax Reform Act of 1986 (the 1986 Act) adopted base-broadening measures designed to increase the overall level of corporate taxes, although it reduced the maximum marginal corporate tax rate from 46 percent to 34 percent. The base broadening was accomplished primarily by repealing the investment tax credit, limiting depreciation deductions, restricting the use of net operating losses, strengthening the corporate alternative minimum tax, repealing the *General Utilities* doctrine, and adopting significant changes in accounting rules, for example, rules requiring uniform capitalization of certain expenditures. As anticipated, the 1986 Act increased corporate income tax receipts (and lowered individual income tax receipts) as a percentage of total income tax receipts. The percentage of income tax receipts accounted for by corporate taxes increased from 15 percent in 1986 to 19 percent in 1989 and dropped back to 17 percent in 1990. The percentage of income tax receipts accounted for by individual income taxes fell from 85 percent to 81 percent, rising to 83 percent in 1990. Current estimates indicate that the 1986 Act increased corporate income tax receipts by approximately $130 billion from 1987 to 1991.

The level of corporate tax receipts depends heavily on economic conditions. When the U.S. economy is growing, corporate profits are strong, and corporate tax receipts increase, but when the economy is in recession, corporate profits tend to fall, and corporate taxes decrease. During the recession of the early 1980s, for example, corporate taxes as a percentage of total budget receipts fell from 10.2 percent in 1981 to 6.2 percent in 1983. This decline was mostly

Figure A.1
Corporate Receipts as a Percentage of Total Receipts and Gross National Product 1940-1991



attributable to the a decline in pre-tax corporate profits, from $202 billion in 1981 to an average of $178 billion in 1982 and 1983.

Foreign countries have a wide variety of tax systems, which make it difficult to compare directly corporate tax burdens across countries, but some general observations can be made. In 1988, corporate income taxes accounted for an average of 8 percent of total income tax receipts for the 22 countries in the OECD. The average in 1988 was the same as in 1980. Although U.S. corporate income taxes were 8 percent of total tax receipts in 1988, the same as the average for the 22 OECD countries, the U.S. percentage is expected to be higher in subsequent years if current trends continue. Countries with percentages higher than the OECD average in 1988 include Japan at 24 percent, the United Kingdom at 11 percent, and Italy at 9 percent; countries with percentages below the OECD average include Germany at 5 percent, France at 5 percent, and Switzerland at 7 percent.[11]

APPENDIX B: EXPERIENCE OF OTHER COUNTRIES WITH DISTRIBUTION-RELATED INTEGRATION SYSTEMS

This appendix briefly describes the distribution-related integrated systems of six of the United States' major trading partners.[1] The Australian and New Zealand imputation credit systems most closely resemble the prototype discussed in Chapter 11. The United Kingdom system is a prominent example of a compensatory tax system. This appendix also discusses the Canadian, French and German distribution-related systems. This appendix does not describe the Japanese corporate tax system, because in 1989 Japan replaced its split rate tax system with a classical system.

B.1 AUSTRALIA

Introduction

Australia's imputation credit system became effective July 1, 1987. Major changes to related tax laws have subsequently taken effect, most notably:

- a reduction in the top corporate rate from 49 percent to 39 percent,
- the imposition of a 15 percent tax on the investment income of pension plans, and the extension to them of the imputation credit (at the full rate of 39 percent), and
- the exemption of most foreign income from the corporate tax base.

Description of Mechanics

Imputation Credits

Australia's imputation credit system makes imputation credits available to taxable shareholders (including pension plans) for distributions from the corporation's franking account. Imputation credits provide full relief from the corporate level tax paid with respect to distributed income. Distributions not paid from the franking account are considered to be paid from preference income and are taxed to the shareholder without gross-up and without credit.

The shareholder receives an imputation credit equal to the amount of distributions from the franking account (franked distributions), grossed-up at the corporate rate (currently, 39 percent), and then multiplied by that rate.[2] The shareholder includes this amount in his income and receives a credit in the same amount against his personal tax liability. Imputation credits generally are not refundable.

The balance in the franking account represents the portion of the corporation's after-tax income that, in effect, has been taxed fully (taxed at the corporate rate). In general, the franking account balance derives from the amount of tax the corporation pays. At the current tax rate of 39 percent, for every AU$39 the corporation pays in tax, it adds AU$61 to the balance of the account. The calculation converts after-tax corporate income that is taxed at various rates into an equivalent combination of fully-taxed and fully exempt amounts.[3] Thus, Australia's system accords shareholders relief only from corporate level tax actually paid with respect to distributed income, and distributed preference income is subject to tax at the shareholder level.

An Australian corporation must make entries in its franking account throughout the year upon the occurrence of specified events in the assessment, payment, and adjustment of tax. The franking account is credited when the corporation: carries forward a franking surplus from the previous year, pays tax, receives franked dividends from another company, is served with a determination reducing the amount of a "franking deficit tax offset," or has an "estimated debit determination" (see "Allocating Credits to Dividends," below) that lapses or substitutes a new estimated debit determination.

The franking account is debited when the corporation: pays franked dividends, has tax refunded, is served with a determination (or increase) of a franking deficit tax offset, receives (or is deemed to receive) notice of an estimated debit determination, e.g., appeals a tax assessment, makes on-market share buybacks; or underfranks a dividend (franks it by less than the required franking amount, if the required franking amount is 10 percent or more of the dividend).

Compensatory or Withholding Tax

The Australian system does not have a compensatory or withholding tax on distributions.

Dividends Defined, Bonus Shares, Share Repurchases

In general, dividends include all non-liquidating distributions of money or other property to shareholders out of profits (under corporate law, the corporation cannot pay dividends as a return of capital without a court order). Liquidating distributions generally are deemed to be dividends to the extent they represent profits.

A corporation can issue bonus shares as a mechanism for extending the imputation system to retained earnings. An issue of bonus shares distributed to a shareholder is treated as a dividend unless it is paid out of the corporation's share premium account (which represents amounts paid on issuance of shares in excess of par value). Thus, if the corporation has a sufficient balance in its share premium account, it can choose the tax treatment of the bonus issue by choosing whether or not to debit the account, subject to certain rules for dividend-streaming arrangements. See "Streaming" below.

The tax treatment of a share repurchase (or "buyback") differs depending upon whether the transaction is an "on-market" or an "off-market" purchase. An on-market buyback occurs in the ordinary course of business on an official exchange; an off-market buyback (a buyback by an unlisted company or by a listed company not in the ordinary course) occurs otherwise .

An off-market buyback is treated as a dividend to the extent it exceeds paid-up capital for the shares (share capital plus the amount, if any, allocated to the buyback from the share premium account). With respect to the dividend portion, the corporation debits its franking account as required under the general rules and the shareholder receives the imputation credit. The shareholder's basis in his stock is irrelevant for dividend purposes but is relevant for the portion treated as return of paid-up capital, so the shareholder could have a dividend and a capital gain or loss on the same transaction.

An on-market buyback is treated as a capital transaction to the shareholder (because he does not know that his buyer is the corporation). The corporation has no gain, loss, or deductions. However, the corporation must treat the buyback as a dividend to the extent it would be a dividend if it were off-market and, with respect to such amount, must debit its franking account under the allocation rules. See "Allocating Credits to Dividends," below. (This notional dividend also might affect any provisional required franking amount for any actual frankable dividend.) No imputation credit is available to the shareholder to offset his capital gain.[4]

Allocating Credits to Dividends

Australia has adopted allocation rules generally designed to assure that a corporation pays dividends first out of the franking account, and to prevent corporations from streaming franked dividends to resident shareholders, who can use imputation credits, and unfranked dividends to foreign shareholders (and tax-exempt shareholders), who cannot. The allocation rules impose a minimum "required franking amount" for a dividend and provide for adjustments and sometimes penalties if a dividend is overfranked or underfranked by more than a de minimis amount.

The required franking amount ideally franks all dividends paid during the year to the extent of the corporation's after-tax income. To ensure that the corporation does not underfrank a dividend, the rules require the company: (1) to take into account all dividends to be paid on the same day, that have been declared but not yet paid, or that the corporation is committed to pay later in the same year (a committed future dividend), such as dividends on preferred stock, in allocating franking credits to a given dividend, (2) to frank a dividend that was a committed future dividend at least to the same extent as the earlier dividend, and (3) to frank a dividend at least to the same extent as any other dividend on the same day.[5] These rules do not, however, prevent a corporation from franking an earlier dividend on one class of stock at one rate and franking a later dividend on another class of stock at a lower rate where the corporation was not committed to pay the later dividend or where the later dividend is paid in the succeeding year. An upper limit on franking is set by reference to the corporate tax rate; at current rates, a dividend of AU$61 can carry no more than AU$39 of imputation credits.

The required franking amount could range from zero, for a corporation with no taxable income, to 39 percent of the dividend, for a corporation with sufficient after-tax income. However, the required franking amount might not be readily determinable when a dividend is distributed during the year, where it is not clear whether the corporation will have sufficient taxable income for that year. The situation also could be complicated by later events, such as a refund of previously paid tax. If, for such a reason, a year-end deficit were to result, the corporation would be subject to a franking deficit tax and possibly a penalty tax. An estimated debit determination is a procedure for resolving this problem; if the corporation expects such a later debit, so the dividends paid would turn out to have been overfranked, the corporation may notify the tax authorities and make an anticipatory debit to its franking account.

If a corporation underfranks a dividend (and if the required franking amount is 10 percent or more of the dividend), the corporation must debit its franking account to the extent of the underfranking. Thus, the corporation is treated as having franked the dividends to the required amount, but the shareholders forfeit the imputation credit attributable to the underfranking.

Where overfranked dividends (or other adjustments) result in a deficit in the franking account at the end of the year, the corporation must pay a franking deficit tax. The franking deficit tax is the amount of tax sufficient to restore the franking account to zero.[6] This tax does not result in a positive credit to the franking account, because it functions as a prepayment of corporate tax prematurely imputed to shareholders by the payment of overfranked dividends. The franking deficit tax is not a penalty, and therefore a corporation may offset a payment of franking deficit tax against its future tax liability. However, to discourage more than de minimis overfranking, a penalty equal to 30 percent of the franking deficit tax is payable where the franking deficit exceeds 10 percent of the total of the franking credits arising during the year and any dividend paid during the year was overfranked.

Tax Rates

The corporate tax rate currently is 39 percent. Marginal tax rates for individuals range from 0 percent to 47 percent. The 47 percent rate applies to taxpayers with taxable income exceeding AU$50,000. Capital gains on assets acquired after September 19, 1985 are taxed at ordinary income rates. However, to determine the amount of gain recognized on disposition of a capital asset, basis in the asset is indexed for inflation if the asset was held for more than 1 year.

Treatment of Preference Income

Dividends paid out of preference income (when the franking account balance is zero) are taxable when received by shareholders and thus corporate preferences are not extended to shareholders.

The Australian system currently provides corporations few preferences. In 1988 Australia reformed its depreciation system and other tax concessions. For example, depreciation rates for "plant" were based on 5 or 3 year lives; now they are based on effective lives (using a 150 percent declining balance or "prime cost") plus a 20 percent "loading." The 150 percent deduction for research and development expenditures is scheduled to be scaled back to 125 percent in the mid-1990s.

Treatment of Domestic Intercorporate Dividends

Dividends received by an Australian corporation from another Australian corporation generally are free of tax because tax is rebated. In addition, credits attached to intercorporate dividends are credited to the recipient corporation's franking account. However, unfranked dividends to private corporations (generally, unlisted corporations) are taxed without refund. This exception is designed to prevent the use of private corporations to defer tax on distributed preference income. Australia does not permit consolidation of affiliated corporations for purposes of its imputation system (or for its corporate tax generally, although there is loss transfer for 100 percent related corporations).

Treatment of Foreign Source Income

Beginning July 1, 1990, foreign source income derived from comparable tax countries through a branch is generally excludable from corporate income. An exemption from corporate tax also applies to dividends received from a corporation resident in a comparable tax country if the Australian corporation owns at least a 10 percent interest in that corporation. Dividends received from portfolio investments (i.e., less than 10 percent) in corporations resident in comparable tax countries are taxable with a credit allowed for foreign withholding taxes. However, because foreign taxes paid with respect to foreign source income derived from comparable tax countries do not generate credits to the franking account, dividends paid by an Australian corporation out of such income do not carry credits in respect of such foreign taxes and are exposed to shareholder level tax. Thus, this foreign source corporate income is still double-taxed, once when earned in the foreign country and once when the after-foreign-tax amount is distributed to domestic individual shareholders.

Income derived from low-tax countries through a branch or a nonresident corporation generally is subject to full taxation at the corporate level with a credit for foreign taxes paid on such income. Where an Australian corporation owns a 10 percent or more interest in a corporation residing in, or deriving substantial income from, a low-tax country, the Australian corporation is taxed currently on its share of the nonresident corporation's income and may credit its share of foreign taxes paid by the nonresident corporation on an "accruals" basis, provided that the foreign corporation is a controlled foreign company (that is, 5 or fewer Australian residents control 50 percent or more of the company). Such a 10 percent shareholder maintains an "Attribution Tax Account" (ATA) for every entity in the chain, in which income is attributed to that entity; when a dividend is paid between entities, a debit is made to the ATA of the paying corporation and a credit is recorded in the ATA of the receiving corporation.[7] Where the Australian corporation owns a lesser percentage, the accruals tax does not apply, but dividends received are subject to Australian tax (with a tax credit for foreign withholding taxes paid on the dividend). Because foreign taxes paid do not generate credits to the franking account, dividends paid out of such income to the shareholders of the Australian corporation are exposed to shareholder level tax. The net effect of this system is the equivalent of allowing a deduction for foreign taxes on distributed foreign source income earned through an Australian corporation.

Treatment of Tax-Exempt Shareholders

Excess imputation credits are not refundable to any shareholder, including tax-exempt shareholders. Accordingly, income taxed at the corporate level is subject to one level of tax even where it is distributed to tax-exempt shareholders.

Until 1988, pension funds were tax-exempt, although distributions were taxable to beneficiaries. The new statute imposes a tax at a 15 percent rate on the investment income of pension funds, but allows pension funds an imputation credit for franked dividends at the full 39 percent rate. Thus, a pension fund can use the excess imputation credits (a 24 percent credit) to shelter the tax on a large amount of other investment income (such as interest, rents, royalties, foreign income, capital gains, and unfranked dividends). Pension funds also may utilize imputation credits to reduce tax imposed on contributions. These changes are designed in part to encourage pension funds to invest in domestic corporations having Australian tax liability, thus reducing the tax arbitrage gains to pension funds from investing in bonds or in corporations paying unfranked dividends.

Treatment of Foreign Shareholders

Australia generally imposes a withholding tax on dividends from Australian corporations to nonresident shareholders. No distinction is made between portfolio and nonportfolio investment. The normal withholding rate is 30 percent, but treaties may reduce this rate to 15 percent. The gross-up and imputation credit procedure does not apply to nonresident shareholders. However, the franked portion of a dividend is exempt from the withholding tax. Thus, the franked portion of a dividend bears Australian tax at the 39 percent corporate rate. Unfranked dividends are subject to withholding tax and, thus, bear Australian tax at the applicable withholding rate.

Treatment of Low-Bracket Shareholders

Although a shareholder may use excess credits to offset any other tax liability he may have, excess credits are not refundable. Unused credits may not be carried forward or back. The imputation credit (aggregated with other nonrefundable credits) is stacked so refunds from other sources cannot impair use of the credit.

Streaming

In addition to the allocation rules described above, Australia has adopted several anti-streaming provisions. First, where a dividend is paid to a corporate shareholder as part of a dividend stripping operation, imputation credits attached to the dividend and the tax rebate for intercorporate dividends may be denied. One effect of the dividend stripping rule is to discourage sales of shares by tax-exempt or nonresident shareholders in anticipation of the payment of a franked dividend. Second, to inhibit streaming through partnerships and trusts, imputation credits received by a partnership or trust are generally allocated in accordance with a partner's or beneficiary's share of partnership or trust income. Third, a special debit to the franking account is required when a corporation distributes an unfranked dividend or tax-exempt bonus share to a shareholder in substitution for a franked dividend as part of a dividend streaming arrangement. Generally, the franking debit is calculated as if the franked dividend had been franked to the same extent as the dividend for which it substituted, thus ensuring equal franking for all dividends paid on a particular class of stock as part of the same distribution.

Treatment of Interest

Interest paid by an Australian corporation generally is deductible. Interest paid to a resident lender is includable in the lender's income. Interest paid to a foreign lender (whether or not resident in a treaty country) is subject to a 10 percent withholding tax. Australia has a thin capitalization rule that denies a resident corporation a deduction for interest paid to foreign shareholders where the foreign shareholders own at least 15 percent of the resident corporation and the resident corporation's debt to equity ratio with respect to the nonresident shareholders' investment is in greater than 3 to 1 (6 to 1 for financial institutions). Beginning July 1, 1990, this rule applies even if the foreign controlling shareholder is in turn controlled by Australian residents.

B.2 CANADA

Introduction

Canada introduced distribution-related integration in 1971 with the adoption of a straight credit system that grants a credit to resident individual Canadian shareholders with respect to dividends received from Canadian corporations. The credit is not required to be funded at the corporate level. That is, the amount of the shareholder credit does not depend on the payment of tax by the corporation. Excess credits are not refundable.

Description of Mechanics

Credits

Where a Canadian resident individual shareholder receives a taxable dividend (described below) from a Canadian corporation, the shareholder grosses up the dividend by 25 percent (i.e., includes 125 percent of the dividend in income) and takes a credit against his Federal individual income tax for 66.7 percent of the amount of the gross-up. Provincial individual taxes are calculated as approximately 50 percent of the shareholder's Federal tax liability (after the reduction for the shareholder tax credit). Thus, the provincial tax is reduced by approximately 33.3 percent of the amount of the gross-up, and the total value of the shareholder credit against the combined Federal and provincial liability of the shareholder is approximately equal to the amount of the gross-up.[8]

The gross-up and credit are not dependent on the payment of Canadian tax at the corporate level. Thus, the shareholder credit may provide full or partial relief from corporate level tax, depending upon the tax rate applicable to the corporation paying the dividend. If no tax is paid at the corporate level, the shareholder credit completely or partially offsets the shareholder level tax, which is the only level of tax that would otherwise apply to the distributed income. For example, a dividend that is paid exclusively out of preference income would carry the full credit, the same as a dividend paid out of Canadian source sales income. In the former case, the corporation pays no Canadian corporate tax and, in the latter case, it pays a net Federal tax of more than 28 percent.

The degree to which the Canadian system integrates corporate and shareholder tax depends on the rate at which distributed income has been taxed at the corporate level under the Federal and provincial tax systems. See "Tax Rates," below. Combining Federal and Ontario provincial tax, the system integrates 32 percent of a regular corporation's tax, 41 percent of a manufacturing corporation's tax, and 86 percent of a small business corporation's tax.[9]

Compensatory or Withholding Tax

Canada does not impose a compensatory or withholding tax on dividends to resident shareholders.

Dividends Defined, Bonus Shares, Share Repurchases

In general, a taxable dividend includes any nonliquidating distribution with respect to shares out of surplus funds. Accordingly, a return of contributed surplus that has not been converted into paid-up capital is a taxable dividend. A liquidating distribution constitutes a taxable dividend to the extent it exceeds paid-up capital (defined to exclude contributed surplus).

A stock dividend is generally treated as a taxable dividend. However, subject to certain exceptions, the amount of the dividend is limited to the increase in paid-up capital in respect of the stock dividend.

A share repurchase generally is treated as a taxable dividend to the extent that the amount paid exceeds the paid-up capital on the shares repurchased. The amount so treated is excluded in determining the shareholder's capital gain or loss. These rules, however, do not apply to a corporation's open market purchases of its shares.

Allocating Credits to Dividends

Because the shareholder credit is not dependent on the actual payment of corporate tax, the Canadian system does not require rules allocating credits to dividends.

Tax Rates

The Federal basic corporate rate is 38 percent. Provincial basic corporate rates generally range from 14 percent to 17 percent. However, an abatement of Federal corporate tax is allowed in respect of provincial tax equal to 10 percent of taxable income earned in a province. In addition, a surtax currently is imposed on corporations equal to 3 percent of a corporation's Federal tax liability. Thus, effective combined Federal and provincial corporate tax rates vary from 42.8 percent to 45.8 percent.

For individuals, Federal tax rates are 17 percent for taxable income up to $28,784, 26 percent for taxable income of $28,784 to $57,578, and 29 percent for taxable income in excess of $57,578.[10] A Federal surtax of 5 percent is currently in place. Provincial tax is imposed as a percentage of Federal tax, varying from 46.5 percent to 62 percent. Some provinces impose a surtax on high-income individuals.

Corporate and individual taxpayers are taxed at ordinary income rates on 75 percent of their net capital gain in a taxable year. For individuals, a lifetime exemption of $100,000 of gain applies. The lifetime exemption is $500,000 for small business shares and farm property. For individuals, in addition to actual realized gain, gain is deemed to be realized with respect to many kinds of assets at death, at the time of transfer by gift or at the time the owner gives up Canadian residence.

Treatment of Preference Income

Because the shareholder credit is not dependent on the payment of tax at the corporate level, the Canadian system can be described as extending preferences to shareholders. However, because the Canadian system may provide less than 100 percent integration of the corporate and shareholder taxes on distributed income, the extension of preferences may be more than offset by the remaining double tax on taxable income. For example, for regular corporations the credit generally equals half of Federal corporate tax. Thus, preferences are not extended to shareholders until preference income exceeds half of total corporate income.[11]

A 5 percentage point reduction in the basic rate of corporate tax (from 38 percent to 33 percent) applies to manufacturing and processing income of a resident corporation. For Canadian small business corporations, a deduction applies that effectively reduces the basic rate by 16 percentage points (from 38 percent to 22 percent). Except for a 35 percent research and development credit, investment tax credits apply only in selected geographic areas. A more generalized investment tax credit was phased out in 1988 as part of tax reform. As discussed above, only 75 percent of net realized capital gains are included in income. Certain assets are eligible for accelerated depreciation.

Treatment of Domestic Intercorporate Dividends

The gross-up and shareholder credit mechanism does not apply to dividends paid by a Canadian corporation to a Canadian corporate shareholder. In general, however, domestic intercorporate dividends are deductible in computing the income of the Canadian shareholder corporation.[12] Thus, preferences generally are not recaptured when preference income is distributed to corporate shareholders. However, for Canadian portfolio dividends received by a private or privately-controlled Canadian corporation, a tax of 25 percent is payable by the recipient corporation and is refunded to the corporation when the dividends are redistributed to shareholders.

Treatment of Foreign Source Income

Resident corporations are taxed on their worldwide income. This includes current taxation on an accrual basis of passive income earned through a controlled foreign affiliate. However, Canada provides exemptions for certain types of foreign source income and a foreign tax credit with respect to certain other types of foreign source income. For example, dividends received from a foreign affiliate resident in a prescribed country out of its active business income in that country or another prescribed country generally are exempt from Canadian corporate tax. Tax credits are allowed with respect to portfolio dividends received from a nonresident corporation, but not for underlying foreign taxes paid by that corporation on the income distributed. The effect of these exemptions and credits is to relieve, in whole or in part, corporate level Canadian tax on foreign source income. Because the shareholder credit does not depend on the extent to which the underlying corporate income has been taxed, the Canadian system extends the benefits of integration to foreign source income to the extent of the shareholder credit.

Treatment of Tax-Exempt Shareholders

Certain persons are excluded from Canadian tax, including charities and pension funds. However, because the shareholder credit is nonrefundable, tax-exempt shareholders do not receive the benefit of Canadian integration.

Treatment of Foreign Shareholders

The Canadian integration system generally is not extended to nonresident shareholders because the gross-up and shareholder credit mechanism does not apply to dividends paid to nonresident shareholders. Dividends paid to foreign shareholders are subject to a withholding tax at a statutory rate of 25 percent. By treaty, Canada typically reduces the rate to 10 percent for direct investment dividends and to 15 percent for portfolio dividends. The 1980 U.S. treaty, reflecting this policy, was the first in which Canada reduced its dividend withholding rate below 15 percent. This concession for direct investment dividends in the U.S. treaty was seen as extending to U.S. direct investors in Canadian corporations some of the benefit of Canadian integration.

Low-Bracket Shareholders

Excess shareholder credits are available to offset income tax liability with respect to other income. Credits not used in the year received may not be refunded or carried forward.

Streaming

The Canadian system includes stop-loss rules that inhibit dividend stripping by requiring that, in certain circumstances, the amount of a loss recognized on a sale of shares be reduced by dividends received on the shares.

In addition, the gross-up and credit mechanism does not apply where a "dividend rental arrangement" exists. A dividend rental arrangement essentially is a transfer of shares where the transferee receives the dividend but the transferor retains the risk of loss and opportunity for gain with respect to the shares. Finally, under a general anti-abuse rule, Canadian tax authorities may deny a tax benefit where there is an avoidance transaction and a misuse of provisions of tax laws. An avoidance transaction is a transaction resulting in a tax benefit unless the transaction reasonably could be considered to have been undertaken primarily for non-tax reasons.

Treatment of Interest

Interest paid by a Canadian corporation is deductible if the interest relates to borrowed money used for the purpose of earning income from a business or property or for acquiring property for gain upon resale. A thin capitalization rule prohibits the deduction of interest paid by a thinly capitalized corporation to nonresident shareholders owning 25 percent or more of any class of the corporation's stock.

Interest income generally is taxable to resident lenders. A withholding tax generally is imposed on interest paid by Canadian corporations to nonresident lenders at the statutory rate of 25 percent. No withholding tax is imposed with respect to interest paid on corporate bonds or debentures to an arm's-length lender if no more than 25 percent of the principal amount is repayable within 5 years of issuance. In addition, the withholding rate may be reduced by treaty to 10 or 15 percent.

B.3 FRANCE

Introduction

The French distribution-related integration system combines three elements: (1) an imputation credit (avoir fiscal), (2) a compensatory tax (precompte mobilier), and (3) for 1989 through 1991, a "split" tax rate on corporate profits.

The avoir fiscal credit was enacted in 1965 and, simultaneously, a 24 percent withholding tax on dividends was repealed. The new system became fully effective in 1967.

In 1989, the French introduced a split rate system, which applies a higher tax rate to distributed profits. The split rate system was designed to provide an incentive for corporate financing through retained earnings and balance the incentive, created by the avoir fiscal, to distribute earnings and to finance through new equity capital. This system has been eliminated, however, beginning in 1992.

Description of Mechanics

Imputation Credits

Upon receipt of an eligible dividend (described below), a French resident individual or corporate shareholder is allowed a tax credit (the avoir fiscal) equal to 50 percent of the amount of the dividend, or 33.3 percent of the amount of the dividend plus the avoir fiscal. A shareholder must include in income both the amount of a dividend payment and the amount of the avoir fiscal.

The gross-up and avoir fiscal partially integrate corporate tax paid on distributed income. For 1991, distributed income is subject to a tax rate of 42 percent at the corporate level. The avoir fiscal, thus, equals 69 percent of the tax paid by the corporation on distributed income and 29 percent of the pre-tax amount of such income. For example, profits of F100 are subject to corporate tax of F42 prior to distribution, leaving a net amount for distribution of F58. A shareholder would include a total of F87 (F58+F29) in income. The avoir fiscal associated with this F87 dividend is F29. For 1992, distributed income will be subject to corporate level tax at the rate of 34 percent. The avoir fiscal will thus equal 97 percent of the tax paid by the corporation on distributed income and 33 percent of the pre-tax amount of such income.[13]

In order to encourage corporate distributions, the avoir fiscal is not allowed to shareholders in respect of dividends paid out of profits realized more than 5 years prior to distribution. In addition, the avoir fiscal is not available to foreign shareholders, unless specific provision is made in an income tax treaty: If the amount of the avoir fiscal exceeds the tax liability of an individual shareholder, the excess is refunded. The same is true for some tax-exempt shareholders. No refund is available to a corporate shareholder.

Split Rate Tax and Compensatory Tax (Precompte Mobilier)

The French split rate tax system, in effect for 1989 through 1991, is unusual in that it applies a higher tax rate to distributed profits than to retained profits. For fiscal years beginning on or after January 1, 1991 and before January 1, 1992, retained corporate profits are taxed at a rate of 34 percent, and distributed corporate profits are taxed at a higher rate of 42 percent. The additional 8 percent is imposed as a surtax in the year of distribution. The application of a higher tax rate to distributed profits was instituted for 1989 through 1991 to encourage corporate saving and investment. Taking into account the avoir fiscal credit allowed to shareholders, the effective corporate level tax rate on distributed taxable income is 13 percent for 1991. Consistent with recent corporate tax rate reductions in the United States and other EC countries, however, the French government recently eliminated the 8 percent surtax on distributed income.

The precompte mobilier is imposed on a distributing corporation in respect of dividends distributed (1) out of profits that have not borne regular corporate income tax at the 34 percent rate, e.g., foreign source income, preference income, and dividends received by a parent company from a 10 percent owned subsidiary or (2) from fully-taxed profits earned more than 5 years before the distribution.[14] The precompte mobilier is imposed at a rate of 50 percent of the amount of the dividend, or 33.3 percent of the dividend plus the precompte mobilier. Thus, the amount of the precompte mobilier is equal to the amount of the avoir fiscal associated with the dividend. No distinction is made in calculating precompte mobilier liability between income that is not taxed and income that is taxed at a rate lower than 34 percent.[15]

French corporations are required to segregate fully-taxed income from income potentially subject to the precompte mobilier for tax accounting purposes. In general, dividends eligible for avoir fiscal are deemed to be distributed first out of current fully-taxed income, and then out of fully-taxed retained income of each of the immediately preceding 5 years. Once fully-taxed income for this 5 year period has been exhausted, a corporation may choose to allocate a dividend distribution to (1) dividends received from foreign subsidiaries, (2) the long-term capital gains reserve, or (3) other miscellaneous preference income in any order. France thus allows stacking of dividends last against preference income.

A French corporation may elect, alternatively, to allocate part or all of a distribution eligible for the avoir fiscal first against dividends received from a French subsidiary within the last 5 years (rather than to current taxable income). Dividends received from French subsidiaries are subject, in principle, to the precompte mobilier. On redistribution, however, the avoir fiscal associated with such dividends may be credited against the precompte mobilier liability.

Dividends Defined, Bonus Shares, Share Repurchases

Distributions are eligible for the avoir fiscal if they are made from corporate income, are made pro rata to shareholders, and are based on a regular decision of the corporation. Repayments of share capital are not taxable, but payments to shareholders are considered to be repayments of share capital only if all of the corporation's earnings and reserves previously have been distributed.

Distributions in liquidation are taxed as ordinary dividends to the extent the distribution exceeds the greater of contributed capital or share basis, and are eligible for the avoir fiscal. To the extent that liquidating distributions are deemed made from preference income, they are subject to the precompte mobilier.

Stock dividends generally are not subject to tax in the hands of a recipient. However, if the distribution of new shares is the result of a reinvestment of cash dividends at the election of the shareholder, the distribution is taxed as an ordinary dividend distribution.

Proceeds from share repurchases are treated as distributions, although only the difference between the value of consideration received and the shareholder's basis in the shares is subject to tax at the shareholder level. The amount distributed does not qualify for the avoir fiscal or trigger the precompte mobilier unless it is paid on a pro rata basis to all shareholders in accordance with a regular decision made by the corporation.

Allocation of Credits to Dividends

The avoir fiscal applies regardless of the rate of corporate level tax actually borne by distributed income.

Tax Rates

For the 1991 tax year, individual marginal income tax rates range from 5 percent to 56.8 percent. France also imposes a net wealth tax at rates, for 1991, ranging from 0.5 percent to 1.5 percent.

For fiscal years beginning on or after January 1, 1991 but before January 1, 1992, undistributed profits are taxed at a flat rate of 34 percent and distributed profits at a flat rate of 42 percent. The higher rate applicable to distributed profits does not apply to profits distributed in the form of a stock dividend. For fiscal years beginning on or after January 1, 1992, all corporate profits (distributed and undistributed) will be taxed at a flat rate of 34 percent.

Net short-term capital gains (generally, gains on the sale of assets held less than 2 years) are included in taxable income and taxed at regular rates in the year realized (subject to certain exceptions that allow gains arising from mergers or similar reorganizations to be spread over periods from 5 to 15 years). Net short-term capital losses are either deductible from operating profits in the year realized or, for a loss corporation, added to the net operating loss (and thereby made available for 5 year carryforward or an elective 3 year carryback).

For dispositions occurring prior to July 1, 1991, net long-term capital gains generally are taxed at a rate of 25 percent. Long-term capital gains on property other than buildings, land and financial instruments are taxed at 19 percent and long-term capital gains on industrial property (e.g., patents) are taxed at 15 percent. Net long-term capital losses may not be used to offset operating profits, but may be carried forward for 10 years to offset future long-term capital gains. The after-tax amount of net long-term capital gain is credited to a special capital gain reserve. When a dividend is deemed distributed out of the capital gain reserve, a compensatory tax is imposed at a rate of 17 percent, equal to the difference between the long-term capital gains tax rate (25 percent) and the tax rate applicable to distributed profits (42 percent). For dispositions occurring on or after July 1, 1991, the French government has replaced the multiple rates on capital gains with a single 18 percent rate. Compensatory tax will thus be imposed at a rate of 16 percent for 1992, equal to the difference between 18 percent and the 34 percent rate applicable to distributed profits.

Treatment of Preference Income

Tax preferences available at the corporate level include special accelerated depreciation for new construction in depressed areas, shares in certain building companies, software acquired from third parties, research installations, and air and water purification installations. Corporations also may be entitled to a tax credit for research and development expenditures, a tax holiday for start-up businesses, and a reduced rate of tax on French headquarters of multinational corporations.

Preferences are not passed through to shareholders, since the precompte mobilier is imposed on distributions of preference income. However, as described above, French law allows preference income to be stacked last.

Treatment of Domestic Intercorporate Dividends

Nonparent Companies

"Nonparent companies" are defined as companies that own less than 10 percent of the issued share capital of the distributing corporation. Nonparent companies are eligible for the avoir fiscal. Like an individual shareholder, a nonparent company must include in income the entire amount of a dividend received from another French company and may use the avoir fiscal associated with the dividend as a credit against its income tax liability. If, however, the nonparent company's income tax liability for the year in which a dividend is received is less than the amount of the avoir fiscal, no refund or carryforward is allowed.

Parent Companies

"Parent companies" are defined as companies that own 10 percent or more of the shares of the distributing corporation. Parent companies are eligible for a "participation exemption" as well as the avoir fiscal. Under the participation exemption, 95 percent of the amount of a dividend received from a 10 percent-owned subsidiary (including the amount of the avoir fiscal) is excludable from taxable income.[16]

The avoir fiscal associated with dividends received by a parent company from its subsidiaries is passed on to the parent's shareholders when the dividends are redistributed. In principle, the precompte mobilier applies to such redistribution, because the subsidiary dividends are almost entirely exempt from tax. The parent company is permitted a deduction, however, for the avoir fiscal associated with the subsidiary dividends and this deduction exactly offsets the parent's precompte mobilier liability. Any available credit for foreign withholding tax paid on the subsidiary dividends also may be used to offset the precompte mobilier. As a result, the shareholders of the parent company are placed in the same position as if they had owned shares in the subsidiaries directly.

Consolidated Groups

A French parent company may consolidate for tax purposes with its direct and indirect 95 percent-owned French subsidiaries. Dividends paid within the consolidated group are subject neither to precompte mobilier nor to corporate income tax.

Treatment of Foreign Source Income

In general, the French integration system does not extend the benefits of integration with respect to foreign income taxes imposed on foreign source income.

Profits earned by a French company through a foreign branch or other permanent establishment generally are excluded from taxable income until they are repatriated to France and distributed to shareholders. Upon distribution of these profits, the precompte mobilier is imposed. However, if a branch profits tax is imposed on the branch income in addition to foreign income tax, and provided the branch is located in a treaty country, the French corporation may credit the branch profits tax against the precompte mobilier.[17]

A French nonparent company is taxed on the net amount of a dividend received from a foreign corporation (after deduction of foreign withholding tax) resident in a nontreaty country and may not credit any foreign withholding tax against its corporate tax liability. Where the foreign corporation is resident in a treaty country, the dividend is grossed up for any foreign withholding tax, which is then allowed as a credit against French corporate tax. Dividends paid by the nonparent company out of foreign source dividend income are subject to the precompte mobilier and qualify for the avoir fiscal.

Under the participation exemption, 95 percent of the amount of a dividend received by a French parent company from a 10 percent-owned foreign subsidiary (including the amount of the avoir fiscal) is excludable from taxable income. Foreign withholding tax is not allowed as a credit against French corporate tax on the foreign source dividend. The precompte mobilier is imposed on, and the avoir fiscal applies to, dividends paid by the French parent company out of foreign source dividends. However, where the foreign subsidiary is resident in a treaty country, the amount of the dividend received by the French parent company is grossed up by the amount of any foreign withholding tax, which may then be credited against the precompte mobilier due upon the redistribution of the foreign source dividend (provided the redistribution occurs within 5 years of the receipt of the foreign source dividend).

As of January 1, 1990, special rules apply to French holding companies. A French holding company is exempt from the precompte mobilier upon redistribution of dividend income received from foreign subsidiaries to its shareholders, if the holding company satisfies three requirements: (1) the exclusive purpose of the holding company is to hold shares in other companies, (2) at least two-thirds of the capital assets of the holding company consist of interests in foreign subsidiaries, and (3) the holding company derives at least two-thirds of its accounting profit (excluding capital gains) from such foreign interests. Generally, the French holding company must hold at least a 10 percent interest in a foreign subsidiary.

Dividends distributed by a qualifying French holding company out of dividends received from foreign subsidiaries are not eligible for the avoir fiscal, but give rise to a tax credit equal to any foreign withholding tax imposed on the foreign subsidiary dividends. If such dividends are redistributed to a holding company shareholder residing in a nontreaty jurisdiction, the standard 25 percent withholding tax imposed on dividends is increased to 50 percent.[18]

Treatment of Tax-Exempt Shareholders

Pension funds, charities, and other tax-exempt organizations are not taxed on dividends received from French corporations, but are subject to tax at a reduced rate of 24 percent with respect to certain types of investment income, including dividends received from foreign corporations.

Tax-exempt organizations generally are not eligible for the avoir fiscal. However, retirement and disability benefit funds, as well as certain foundations and associations of "public utility," are granted a refundable avoir fiscal with respect to dividends received from French corporations.

Treatment of Foreign Shareholders

Dividends paid by a French company to a foreign shareholder are subject to French withholding tax at a rate of 25 percent, subject to reduction by treaty. The avoir fiscal is not generally available to foreign shareholders (whether individuals or corporations). This is the case even if a French corporation distributes income subject to, and pays, the precompte mobilier.

France has extended the avoir fiscal (by means of a cash refund) to shareholders of a French corporation who are resident in some treaty countries and who (1) are subject to income tax in their residence country on dividends received from the French corporation and (2) do not qualify for exemption or foreign tax credit relief in respect of deemed-paid foreign corporate taxes, i.e., individuals and corporate portfolio investors.

The avoir fiscal refund is subject to French withholding tax at a rate of 25 percent, subject to reduction by treaty. Under some treaties, 10 percent corporate shareholders (nonportfolio shareholders) and other nonresident shareholders not entitled to the avoir fiscal refund are allowed a refund (subject to withholding tax) of any precompte mobilier imposed in respect of dividends received.

Under the United States treaty, for example, the avoir fiscal is refunded to shareholders who are either (1) United States resident individuals or (2) United States corporations that own less than 10 percent of the issued share capital of the distributing corporation and that do not qualify for the indirect foreign tax credit under IRC § 902 (corporate portfolio shareholders). The avoir fiscal is treated as an additional dividend amount and is subject to a 15 percent withholding tax. United States corporations that are 10 percent shareholders of the distributing corporation (nonportfolio shareholders) are not eligible for an avoir fiscal refund, but are entitled to a reduced 5 percent withholding rate on dividends and to a refund of the precompte mobilier.

Treatment of Low-Bracket Shareholders

The avoir fiscal is refundable to low-bracket shareholders.

Streaming

France does not have specific rules to prevent streaming, although the avoir fiscal is available only with respect to a distribution made pro rata to all shareholders.

Treatment of Interest

Interest paid to third parties who are not shareholders and who do not have legal or effective control over the payor is deductible at the corporate level.

Interest from corporate indebtedness is generally included in the taxable income of a resident lender (collected in part by withholding). Resident individuals holding certain fixed income securities may elect to have interest taxed at a flat rate collected by withholding. For 1991, the flat rate is 27 percent for income from bonds.

Interest from corporate indebtedness generally is subject to a withholding tax imposed at statutory rates from 25 percent to 51 percent. However, interest on bonds paid abroad is exempt. Reduced treaty rates also may apply.

B.4 GERMANY

Introduction

The German integration system has both a split rate tax and an imputation credit system with a compensatory tax. The split rate tax applies a "statutory" rate (currently 50 percent) to retained income and a lower "distribution" rate (currently 36 percent) to distributed income. The imputation credit mechanism imputes to shareholders the corporate level income tax paid on distributed income. In general, the shareholder receives a credit based on the distribution rate regardless of the corporation's actual tax liability. However, as discussed more fully below, the corporation may become liable for compensatory tax if it has not paid tax on distributed income at the full distribution rate.

Description of Mechanics

Imputation Credits

Imputation credits are available to any shareholder subject to German tax on his worldwide income. This generally excludes nonresident aliens, foreign corporations, and domestic entities not subject to German tax (although imputation credits are available to a foreign corporation or nonresident that holds the shares as part of a permanent establishment in Germany).

In general, dividends are subject at the corporate level to a creditable 36 percent distribution tax (described below) and to a 25 percent withholding tax at the corporate level. The withholding tax is imposed on the amount of the declared distribution. Thus, a distribution of DM64 is reduced by DM16 of withholding tax, leaving a cash distribution of DM48. The withholding tax applies without regard to whether the stock of the distributing corporation is held publicly or privately, or by domestic or foreign shareholders. (The effect of tax treaties on withholding is discussed below.) In some circumstances the government will grant an exemption certificate to the shareholder which, when provided to the withholding agent, will exempt the shareholder from withholding.

The shareholder must gross up the amount of the dividend by the amount of the withholding tax plus the imputation credit (equal to 36/64 of the declared distribution). Thus, a cash dividend of DM48 (net of withholding tax) is grossed up to DM64 (for the withholding tax), and the resulting DM64 is then grossed up to DM100. The shareholder reports the grossed-up distribution as income and claims a credit equal to the amount of the total gross-up. If the credit exceeds the shareholder's tax liability, the shareholder receives a full refund of the excess; if the shareholder's tax liability exceeds the credit, the shareholder must pay the excess.

Compensatory Tax

The German system uses an "available net equity" account to track taxable and preference income with both the split rate tax and the imputation credit mechanisms. Available net equity represents after-tax corporate income and certain other balance sheet items available for distribution. Available net equity is divided into baskets representing the rate at which the income was taxed. These "Eigenkapital" (equity capital) baskets, abbreviated "EK," are:

- EK 56, containing available net equity from income taxed at the pre-1990 statutory rate of 56 percent. (As of January 1, 1995, the balance in this basket will be "emptied" into the EK 50 basket at a rate equal to 56/44 of the amount in the EK 56 basket.)
- EK 50, containing available net equity from income taxed at the post-1989 statutory rate of 50 percent.
- EK 36, containing available net equity from lesser taxed income that has been converted into an equivalent amount of income taxed at 36 percent, and thus matches the distribution rate of 36 percent (see discussion below).

- EK 0, containing available net equity from income subject to no corporate tax. EK 0 is further divided into four categories: EK 01, containing foreign source income realized after 1976 (the imputation credit became effective in 1977), EK 02, containing items not included in EK 01, 03 or 04, for example net operating losses (discussed below) and distributions made when there is no available net equity in any category (in the latter case, the corporation pays the 36 percent compensatory tax and includes the distribution in EK 02 as a negative item, permitting the corporation to later distribute an offsetting amount of EK 0 without a compensatory tax), EK 03, containing available net equity from years before 1977, and EK 04, containing shareholder contributions to capital in years after 1976.

Fully-taxed income (EK 56 or 50 income) is considered distributed first, followed next by EK 36 income, and last by EK 0 income.

Germany implements its split rate tax by refunding to corporations the excess tax paid on distributions out of EK 50 and EK 56.[19] Distributions out of EK 36 generate neither a refund nor extra corporate tax. Distributions out of EK 0 (other than EK 04) are subject to a compensatory tax of 36 percent. If the corporation has DM100 in its EK 01 account, for example, it may pay the shareholder only DM64—the original DM100 in the account net of a 36 percent distribution tax. The additional tax is added to the corporation's total tax liability for the year to which the distribution is assigned. Distributions out of EK 04 (contributions to capital) generate no tax to the corporation and are excluded from the shareholder's income (as a return of capital).[20]

There are generally no time limits on relief. Thus, a distribution from EK 56 earned in 1977 produces the same credit for corporate tax paid as a distribution from EK 56 earned in 1989. This means that the available net equity accounts need not be segregated into vintage accounts, and instead may be kept as "pools." Income earned prior to 1977, however, is placed in the EK 03 category, and thus there is no imputation relief at the shareholder level for German corporate taxes paid on such income.

A corporation might actually pay tax on certain income at rates other than those for which corresponding EK categories exist. (A substantial portion of such income is foreign source income, discussed below.) The German imputation system converts income subject to some other effective tax rate into appropriate amounts of EK 50, EK 36, and EK 0 income. The conversion formula maximizes the amount of pre-tax income converted into income taxed at the 36 percent distribution rate, since distributions from EK 36 neither entitle the corporation to a refund nor require the payment of compensatory tax. If the corporation's effective tax rate exceeds 36 percent, the remainder of its income is converted to EK 50 income; but if the corporation's effective tax rate falls short of 36 percent, the remainder of its income is converted to EK 0 income.[21] For example, if the corporation has pre-tax income of DM100 on which it pays German tax of DM40, then the effective tax rate is greater than .36 (40/100 = .40), and so a portion of the income will be converted into income taxed at the 50 percent statutory rate.[22] By contrast, if the corporation has pre-tax income of DM100 on which it pays German tax of DM25, then the effective tax rate is less than .36 (25/100 = .25), and so a portion of the income will be converted into income taxed at a zero rate.[23]

The EK accounts are determined at the end of the taxable year.[24] A distribution is classified according to the accounts for the year preceding the year of the dividend declaration.

Dividends Defined, Bonus Shares, Share Repurchases

Any distribution of cash or property (whether liquidating or nonliquidating) is a taxable dividend for German tax purposes unless it is a distribution out of EK 04 or otherwise is a repayment of share capital.

Stock dividends are not subject to the distributions tax and are not taxable to shareholders. However, in certain circumstances, distributions in reduction of share capital within 5 years of the stock dividend (to the extent not in excess of the increase in share capital resulting from the stock dividend) are taxable as dividends and are subject to a penalty tax.

Stock corporations generally are prohibited from making share repurchases under German corporate law. A GmbH is permitted to make share repurchases but is effectively required to finance them out of retained earnings (as opposed, for example, to borrowing against unrealized appreciation in its assets). Share repurchases are not subject to distribution tax at the corporate level and are capital gains transactions at the shareholder level.

Allocation of Credits to Dividends

As discussed above, Germany applies a uniform rate for purposes of determining the shareholder credit regardless of the rate of corporate tax that the distributed income has actually borne.

Tax Rates

Before 1990, individual marginal rates ranged from approximately 22 percent to 56 percent (effective for income exceeding DM130,000). Beginning in 1990, marginal rates range from approximately 19 percent to 53 percent (effective for income exceeding DM120,000).

There is a flat rate of 50 percent for retained profits (before 1990, the rate was 56 percent). This rate is reduced to 36 percent for distributed profits. Certain German "public banks" (banks generally owned by municipal or other public bodies) and German branches of foreign corporations are subject to a flat rate of 46 percent (pre-1990, 50 percent). (See below for a discussion of German branches.) Income sourced in the former western sector of Berlin is subject to a special tax rate of 38.75 percent (pre-1990, 43.4 percent). West Berlin branches of foreign corporations are subject to a special tax rate of 35.65 percent (pre-1990, 38.75 percent). The special tax rate for such income, however, is being phased out over a number of years as a result of unification.[25]

Gains from sales of stock by individuals are exempt unless (1) the sale is connected with a business, (2) the stock is held 6 months or less, or (3) the shareholder owned more than 25 percent of the company's stock at some time during the preceding 5 years. Business and short-term gains are taxable to individuals at normal rates, except that short-term gains are exempt up to DM1,000 each year. Short-term losses may be netted against short-term gains. Gains by substantial individual shareholders are taxed at one-half the normal rate up to the first DM30 million of net gain and at the normal rate thereafter. Gains from exchanges of stock in a liquidation or redemption are treated as sales (except for any portion that is taxed as a dividend distribution).

Gains from sales of stock by corporations are taxable as ordinary income.

Effective for the period July 1, 1991, through June 30, 1992, Germany has imposed a tax on each taxpayer equal to 7.5 percent of the tax that such person would otherwise pay. The surtax applies to all individual and corporate taxpayers, foreign shareholders subject to dividend withholding tax, and German branches of nonresident corporations. For taxpayers using a calendar taxable year, the surtax has the effect of a 3.75 percent surtax in each of the 1991 and 1992 taxable years.

Treatment of Preference Income

Investment incentives in Germany generally take the form of accelerated depreciation for certain industries or regions of the country; there is no investment tax credit. There are special low corporate rates for income derived from the former western sector of Berlin (these rates, described above, are being phased out). Government "incentive grants" (in the form of cash awards) are awarded in certain cases (usually related to research and development and energy production).

The benefit of preferences that take the form of accelerated depreciation is not extended to shareholders. The benefit is eliminated through the 36 percent compensatory tax applied to distributions out of EK 0. Preferences are stacked according to the EK accounts, as indicated. Thus, fully-taxed income (EK 56 or 50) is distributed first, and EK 0 is distributed last.

The benefit of the current reduced tax rate for West Berlin income is extended to shareholders. Such income is deemed to have borne the full imputation burden (EK 50 or EK 56).

Treatment of Domestic Intercorporate Dividends

Dividends paid to domestic corporations are treated exactly the same as dividends paid to resident individuals. The dividends are subject to the 36 percent distributions tax. The recipient corporation must include the grossed-up distribution in income and is entitled to claim the imputation credit. Therefore, preferences are recaptured at the corporate level on intercorporate dividends. No exemption from these rules is provided even where the distributing corporation is a subsidiary of the recipient corporation.

Treatment of Foreign Source Income

German corporations are subject to German corporate tax on their worldwide income. However, Germany has two methods for relieving double taxation with respect to foreign profits: by statute, it gives a foreign tax credit and, by treaty, it exempts foreign business profits earned by a domestic corporation (and gives no credit).

The foreign tax credit is not treated as tax paid for purposes of the imputation credit. In effect, foreign taxes are treated as deductible expenses for purposes of applying the imputation system. If the profits are covered by a treaty exemption, then the profits (net of foreign tax) are simply placed in EK 01 and are subject to the 36 percent distribution tax when paid to shareholders. If the profits are not covered by a treaty exemption, they are subject to a residual German corporate tax, as in the United States. In applying the imputation system to this latter class of profits, it is assumed that the profits (net of foreign tax) were subject to a rate of German tax equal to the residual tax divided by the net profits.

Treatment of Tax-Exempt Shareholders

In Germany, the tax-exempt sector is divided into two separate groups for tax purposes: (1) public law corporations or bodies, e.g., the government and certain central banks, and (2) charitable organizations, including religious groups. Charitable organizations are exempt at the shareholder level, but public corporations are subject to one-half of the normal withholding tax of 25 percent.

In general, neither group is entitled to the imputation credit. However, the imputation credits are refunded where the dividend is paid out of EK 01 (foreign source income that has not borne German tax) or EK 03 (pre-1977 profits). In addition, all shareholders (except shareholders of foreign corporations with German branches) benefit from the 36 percent distribution rate on distributed profits.

Treatment of Foreign Shareholders

Income distributed to foreign shareholders, like all other income, is taxed at the corporate level at the distribution rate rather than at the statutory rate. No distinction is made, for this purpose, between portfolio and direct shareholders.

Dividends to direct and portfolio foreign shareholders are subject to the statutory withholding tax of 25 percent, except where reduced by treaty. Treaties frequently reduce the rate from 25 percent to 15 percent for direct corporate shareholders that are residents of the treaty partner. In some cases, the reduction applies to all residents of the treaty partner. (This was, for example, the treatment provided in the 1954 U.S.-Germany treaty).[26] Foreign shareholders also will be subject to the 7.5 percent surtax previously described. The surtax will be refunded to shareholders entitled to limited withholding under a tax treaty.

In general, foreign shareholders are not entitled to the imputation credit, and the withholding tax applies to the dividend without gross-up. Although Germany has not extended the imputation credit to foreign shareholders, it has been willing to reduce withholding rates by treaty, in part in recognition of the benefits of its imputation system to resident shareholders. In the new U.S.-Germany treaty that entered into force on August 21, 1991 (generally effective retroactive to January 1, 1990), Germany grants a 5 percent withholding rate for direct corporate shareholders (10 percent prior to 1992) and a 10 percent withholding rate for U.S. portfolio shareholders. Under the treaty, the United States agreed to treat the additional relief for portfolio investors as a dividend resulting from a refund of German corporate tax equal to 5.88 percent of the declared dividend; the entire amount (declared dividend plus refund) is considered to have been subject to a 15 percent German withholding tax. Thus, for U.S. tax purposes, if a German corporation declares a dividend of DM100 payable to a U.S. individual shareholder, the dividend will, in effect, be grossed up to DM105.88. After application of a 15 percent withholding rate, the shareholder will receive a net amount of DM90 and be eligible for a foreign tax credit of DM15.88.

Foreign shareholders are entitled to a refund (subject to withholding tax) of the 36 percent distribution tax imposed on two types of distributions: (1) distributions out of foreign source income and (2) distributions out of domestic source income earned prior to the adoption of integration in 1977. The refund is only for the 36 percent distribution tax, not for the foreign or pre-1977 taxes. Refunds paid to foreign shareholders with respect to such distributions are subject to 25 percent withholding unless a treaty provides for a reduced rate. In the latter case, the reduction is granted directly by the government, eliminating the need to apply for a refund of excess withholding.

German branches of foreign corporations are subject to a corporate tax rate of 46 percent (pre-1990, 50 percent). There is no reduction in the corporate rate when the profits are remitted to the home office or distributed to the foreign corporation's shareholders (nor is there imposed a branch tax, as under IRC § 884); the distribution of the profits to the shareholders is not subject to German withholding; and the shareholders are not entitled to any imputation credit with respect to the German corporate tax.[27]

Treatment of Low-Bracket Shareholders

As discussed above, excess credits are fully refundable to low-bracket shareholders.

Streaming

An anti-streaming rule applies where (1) a shareholder sells a substantial interest in a German corporation (i.e., shares with a value of more than DM100,000), (2) the shareholder is not entitled to the shareholder credit (i.e., a tax-exempt or foreign shareholder), (3) the shareholder sells the shares to a person entitled to the credit (i.e., a German resident), and (4) the gain realized on the sale is not subject to German tax. In such case, the acquiror is not allowed to recognize loss on disposition of shares within 10 years to the extent the loss is attributable to dividends paid by the German corporation.

Treatment of Interest

Interest paid by German corporations on indebtedness incurred for business purposes generally is deductible. However, interest paid by an undercapitalized subsidiary to a related party may be recharacterized as a hidden dividend.

Interest paid by German corporations to resident lenders is includable in income. Interest paid by German corporations to nonresident lenders generally is not subject to any German withholding tax. Interest paid on participatory or convertible bonds, however, is subject to withholding at a statutory rate of 25 percent rate. Lower treaty rates or treaty exemptions may apply.

B.5 NEW ZEALAND

Introduction

New Zealand adopted an imputation credit system beginning with the tax year starting April 1, 1988.

Description of General Mechanics

Imputation Credits

For purposes of shareholder level taxation, the amount of a dividend includes the amount of imputation credits that the corporation allocates to the dividend (see "Allocating Credits to Dividends," below) from its "imputation credit account" (ICA). The imputation credits are then creditable against shareholder tax liability. Excess credits are not refundable but do convert into an equivalent loss carryforward.

The New Zealand system requires every taxable domestic corporation to maintain an ICA. The ICA is a memorandum account that runs from April 1 to March 31, regardless of the corporation's fiscal year. The first imputation year ran from April 1, 1988, to March 31, 1989. Unlike Australia's year-to-year franking account, the ICA is a continuing account, and so a negative year-end balance in the ICA results in a tax levy.

The ICA is credited when the corporation pays New Zealand income tax or receives imputation credits attached to dividends paid by another corporation. Where a refund of tax becomes due because of a revised tax assessment, the amount of the refund available is limited to the closing balance of the ICA for the previous year. The amount of a refund in excess of the balance is carried forward and may be used to reduce future tax liability of the corporation.

The ICA is debited when the corporation attaches imputation credits to dividends paid to shareholders, receives refunds of New Zealand income tax, or alters its credit ratio without making a ratio change declaration. See "Allocating Credits to Dividends," below. A closing debit must be cleared within two months by making a "further income tax" payment—available to offset future income tax liabilities, but not arrears—and also results in a 10 percent penalty.[28] See also "Streaming" below.

Compensatory or Withholding Tax

New Zealand does not impose a compensatory tax. Recently, New Zealand introduced a withholding tax for dividends paid to residents that do not carry imputation credits. Technically, the resident withholding tax is imposed on all dividends at a rate of 33 percent (the higher individual marginal rate), but an offset is allowed to the extent the corporation is passing through imputation and foreign source dividend withholding payment credits allocated to the dividend. (See "Treatment of Foreign Source Income" below for a discussion of the "dividend withholding payment" relating to foreign source dividends.) As with imputation credits, the amount of the dividend includes the resident withholding tax paid and the withholding tax is creditable against shareholder tax liability. However, excess resident withholding tax credits are refundable.

Dividends Defined, Bonus Shares, Share Repurchases

In general, all nonliquidating distributions to shareholders are treated as taxable dividends (under corporate law, the corporation cannot pay dividends as a return of capital without a court order); on liquidation, the amount in excess of paid-up capital is a dividend.

A taxable bonus issue, although technically not a dividend, may carry imputation credits. A corporation with profits essentially may elect whether to treat a bonus issue as taxable. In addition, a bonus issue is taxable if shareholders may elect to receive cash in lieu of stock. However, the importance of bonus issues as a mechanism for extending the imputation system to retained earnings is reduced, because, as described under "Tax Rates," below, New

Zealand does not impose tax on capital gains (including gains on sales of stock of New Zealand corporations).

In the case of share repurchases, the amount treated as a dividend is limited to the excess of the amount paid over the sum of the stated capital and qualifying premium with respect to the share. The qualifying premium is equal to the proportionate share of the subscription premium paid on issuance of the class. The limitation applies, however, only if the Inland Revenue Department is satisfied that the shares are not being redeemed pursuant to an arrangement to redeem shares in lieu of the payment of dividends.

Allocating Credits to Dividends

New Zealand's imputation statute does not require a corporation to allocate any credit to a dividend, but certain allocation rules significantly limit a corporation's flexibility to reduce opportunities to stream imputation credits to shareholders who can best use them. The maximum amount that can be allocated to a dividend is determined by multiplying the dividend by a fraction, the numerator of which is the corporate tax rate and the denominator of which is one minus the corporate tax rate. Once the corporation allocates credits to a dividend, the corporation has established the "benchmark" imputation ratio, and the corporation must generally use the same ratio in allocating credits to any other dividend paid in the same imputation year on any class of stock. The corporation may change its ratio, if it files with the Inland Revenue Department a "ratio change declaration" showing that the change is made for commercial reasons and not to convey an imputation credit benefit to one group of shareholders over another. If the corporation uses a ratio different from the benchmark and has not filed a ratio change declaration, it must debit its ICA by the amount by which the account would have been debited if all dividends that year had been credited at the highest rate used that year. Additional tax and penalties are due if, as a result, the closing balance is negative.

Tax Rates

The corporate tax rate is currently 33 percent. Individuals pay tax at two marginal rates: 24 and 33 percent. The 33 percent rate applies to individuals with taxable incomes exceeding NZ $30,875, adjusted for inflation. New Zealand currently imposes no tax on capital gains.

Treatment of Preference Income

Because a corporation may attach credits to dividends only to the extent of taxes actually paid by it, corporate tax preferences generally are not extended to shareholders. When preference income is distributed as an uncredited dividend, the amount of the dividend, in general, is subject to resident withholding tax. However, subject to the credit allocation limitations described above, a corporation may choose the order in which taxable income and preference income are considered distributed. In addition, New Zealand recently attempted to eradicate most tax preferences. Various concessions remain for certain industries, most relating to timber, livestock, farming and fishing. New Zealand also offers certain export incentives. The research and development deduction is 100 percent, with special rules for depreciable property.

Treatment of Domestic Intercorporate Dividends

Until April 1, 1992, corporations are exempt from tax on the receipt of domestic source dividends. Any imputation credits attached to such dividends are credited to the recipient's ICA and may be used to frank dividends to its shareholders. The effect of this system is preserve corporate tax preferences until preference income is distributed out of corporate solution.

Under a recent decision of the New Zealand Government, domestic source dividends are not exempt from tax when received by a corporate shareholder on or after April 1, 1992. Instead, the normal gross-up and credit rules apply and a corporate shareholder thus will be taxed on the receipt of an unfranked, domestic source dividend. The reason for this change is to prevent corporations with tax losses from effectively transferring the losses to corporate shareholders through the issuance of redeemable preference shares and using the proceeds to invest in interest-bearing securities. Another effect of the change is to recapture preferences on the distribution of preference income to a corporate shareholder.

To mitigate the effect of the repeal on affiliated groups of corporations and for other reasons, a group of corporations with 100 percent common ownership is allowed to consolidate for tax purposes. A consolidated group would maintain a single ICA and intercorporate dividends would be ignored.

Treatment of Foreign Source Income

Foreign source income other than dividends is includable in income, and New Zealand allows a credit for foreign taxes paid. Because a corporation credits its ICA only with any additional New Zealand corporate tax paid, foreign taxes do not give rise to imputation credits, and dividends to shareholders of a New Zealand corporation paid out of foreign source nondividend income are exposed to a second level of tax. Foreign source dividends received by New Zealand corporations are exempt from tax but are subject to a "dividend withholding payment" as described below. Foreign taxes paid on the dividend generally are not added to the ICA and, accordingly, dividends paid to shareholders of the New Zealand corporation out of foreign source dividend income also are subject to shareholder level tax. Special rules apply to income derived from controlled foreign corporations (CFCs). The net effect of the New Zealand system is the equivalent of allowing a deduction for foreign taxes on distributed foreign source income earned through a New Zealand corporation.

Dividend Withholding Payment Account (WPA)

New Zealand enacted a withholding payment system (at the 33 percent corporate rate) that applies to all foreign source dividends received by New Zealand resident corporations. The payment is designed to approximate the income tax that a New Zealand individual shareholder would pay on a dividend from a nonresident company. The corporation makes dividend withholding payments only to the extent the New Zealand corporate tax rate exceeds the foreign withholding tax rate.

Although styled a withholding payment, the payment is imposed when the corporation receives the foreign dividend, regardless of whether it makes a distribution to its own shareholders. However, the corporation records the dividend withholding payments in its ICA, and thus can pass through a credit to its shareholders when it pays dividends. Alternatively, the corporation may establish a separate Withholding Payment Account (WPA) and allocate dividend withholding payment credits from the WPA to its shareholders. A WPA might be desirable because the imputation credit is nonrefundable and can only be converted into a loss, but the dividend withholding payment credit is refundable to shareholders. In addition, only dividend withholding credits are creditable against the withholding tax that applies to dividends paid to nonresident shareholders. Accordingly, a corporation that owns significant interests in nonresident companies and that is owned in significant part by tax-exempt or foreign shareholders will find the additional paperwork of a separate WPA worthwhile.

The WPA is maintained under rules similar to the ICA rules. The WPA is credited when the corporation pays dividend withholding payments, and when it receives dividends bearing dividend withholding payment credits. The WPA is debited when dividend withholding payment credits attach to dividends paid to shareholders, and when the corporation chooses to transfer any part of a WPA closing credit balance to its ICA. If the corporation has an income tax loss carryforward, or expects to generate one, it may reduce that loss to satisfy all or part of the dividend withholding amount payable (or obtain a refund of payments). A closing negative balance in the WPA must be satisfied with a "further" dividend withholding payment (which may be credited against future dividend withholding payments due, but cannot be refunded). A debit closing balance, in addition, automatically incurs a 10 percent penalty.

Dividend withholding payment credits may be allocated to dividends paid to shareholders under rules similar to and coordinated with the allocation rules for imputation credits.

Branch Equivalent Tax Account (BETA)

The Branch Equivalent Tax Account (BETA) regime is designed to reduce the potential for deferring New Zealand tax by accumulating income in low-tax countries. A CFC is a foreign corporation (not resident in Australia, the United States, the United Kingdom, Japan, France, Germany or Canada) in which five or fewer New Zealand residents have a controlling (50 percent or more) interest.[29] Any New Zealand resident with a 10 percent interest in a CFC must include in income its proportionate share of the CFC's income and receives credit for its proportionate share of foreign income taxes paid by the CFC. Any New Zealand tax paid is then credited to the BETA (or to the ICA if the corporation does not elect to maintain a separate BETA). Credits from a BETA can be used to satisfy the dividend withholding payment liability on later dividends actually received from the CFC. When BETA credits are so used to satisfy the WPA liability, a corresponding credit to the ICA is made.

Treatment of Tax-Exempt Shareholders

New Zealand has a small tax-favored investor sector. Under recent reforms, New Zealand fully taxes pension plans. At the same time the new imputation scheme went into effect, New Zealand conformed the treatment of Maori authorities to that of corporations (or, in appropriate cases, to that of trusts). In addition, New Zealand repealed the income tax exemption on "qualifying activities" enjoyed by certain cooperatives dealing in primary products.

For tax-exempt charitable and governmental shareholders, imputation credits in excess of tax liability are not refundable. However, such tax-exempt shareholders are exempt from resident withholding tax so preferences are not recaptured where preference income is distributed to them.

Treatment of Foreign Shareholders

In general, the benefits of the imputation credit system generally are not extended to foreign shareholders. New Zealand imposes a nonresident withholding tax at the rate of 30 percent for dividends, with no difference in treatment of portfolio and nonportfolio investors. In some cases, treaties reduce that rate, but to no less than 15 percent. Imputation credits are not creditable against nonresident withholding tax (although dividend withholding payment credits are creditable against such tax).

Low-Bracket Shareholders

Excess imputation credits are available to offset any other tax liability of the taxpayer, but are not refundable. Imputation credits not used in the year that they are received convert into a loss, which carries forward indefinitely. Excess dividend withholding payment credits and resident withholding tax credits are refundable.

Streaming

In addition to the allocation rules discussed above, New Zealand's imputation system contains several anti-streaming provisions. The ICA, WPA, and BETA must be debited to reverse a credit where, after the credit arises, the corporation undergoes a change of beneficial ownership of more than 25 percent (34 percent after April 1, 1992).[30] In addition, the ICA and WPA are debited if there is a "shareholder or company tax advantage arrangement" (a streaming arrangement). The use of credits by shareholders is denied if the shareholders are party to such an arrangement of if there is an arrangement for the shareholder to be paid a dividend by another company. The latter provision applies, for example, where streaming is accomplished through stapled share arrangements.

Treatment of Interest

Interest paid by a New Zealand corporation is generally deductible. Interest paid to a resident lender is includable in the lender's income and, with certain exceptions, is subject to a withholding tax imposed at a rate of 24 percent. Withholding tax at a statutory rate of 15 percent is imposed on interest paid to a foreign lender. The New Zealand Government recently announced its decision to exempt from withholding tax interest paid on debt issued on or after August 1, 1991 by "Approved Issuers" (issuers that agree to pay a levy equal to 2 percent of the amount of the interest paid for the right to pay exempt interest). In addition, in some cases, treaties reduce the withholding rate, but to no less than 10 percent.

B.6 UNITED KINGDOM

Introduction

The United Kingdom provides for distribution-related integration of the individual and corporate income tax systems by allowing a credit for corporate tax paid with respect to distributed earnings. The amount of the credit is determined as though the corporation had paid tax at the "basic" individual rate, currently 25 percent, rather than at the corporate rate, currently 33 percent (except for small corporations, which may be taxable at a 25 percent rate). Thus, the credit provides only partial relief (except for small corporations) from corporate level tax because actual corporate tax paid with respect to distributed earnings is not fully creditable at the shareholder level.

Description of Mechanics

Imputation Credit

When a corporation makes a "qualifying distribution" (described below) to its shareholders, the distribution carries with it an imputation credit. The shareholder includes the amount of the credit in his taxable income in addition to the amount of the distribution and may use the credit against his income tax liability. The amount of the imputation credit equals the amount of net qualifying distributions, grossed up at the basic personal rate (25 percent), and then multiplied by that rate.[31] Accordingly, if the shareholder's actual marginal tax rate equals the basic rate, then the shareholder owes no tax on the distribution. Generally, the imputation credit is refundable to all resident, non-corporate shareholders, including tax-exempt shareholders.

Compensatory or Withholding Tax

The United Kingdom imposes an "Advance Corporation Tax" (ACT) on qualifying distributions equal to the amount of corporate tax imputed to shareholders (at a 25 percent grossed-up rate). The corporation may apply ACT payments against its regular tax liability (mainstream tax) subject to the limitations described below. Because preference income generates no mainstream tax, ACT effectively recaptures preferences at the corporate level on the distribution of preference income, thereby assuring that preference income ultimately is taxed at shareholder rates.

The amount of ACT that may be applied against mainstream tax is limited to an amount that equals 25 percent of the corporation's taxable income for the year. Excess ACT may be carried back for up to 6 years and may be carried forward indefinitely. Alternatively, current year and surplus ACT can be surrendered to a more than 50 percent-owned subsidiary. Because excess ACT is not refundable, uncredited ACT represents an additional tax liability to the corporation until the corporation earns sufficient additional taxable income to absorb it. In practice, because of the numerous tax preferences provided by U.K. law, many corporations carry excess ACT credits on their books.[32]

Dividends Defined, Bonus Shares, Share Repurchases

The U.K. system generally defines a qualifying distribution to include any non-liquidating distribution of cash or property made by a corporation with respect to its shares, other than a repayment of share capital. Liquidating distributions are not treated as qualifying distributions, and thus neither the ACT nor the gross-up and credit mechanism applies.

Bonus issues are not qualifying distributions. This rule prevents corporations from having to pay ACT on bonus issues. However, cash distributions on bonus issues of redeemable shares made within 10 years of their issuance generally are qualifying distributions even if paid out of share capital.

Share repurchases are generally treated as qualifying distributions to the extent that the amount paid exceeds share capital, and the corporation must pay ACT on the amount so treated.

Allocation of Credits to Dividends

Because the gross-up and credit mechanism described above applies to each qualifying distribution at the assumed 25 percent rate, no allocation rules are necessary.

Tax Rates

The corporate rate, until recently, was 25 percent for income up to £100,000 and 35 percent for income greater than £500,000. (The U.K. system phases out the reduced corporate rate, which resulted in a marginal rate of 37.5 percent for corporate income between £100,000 and £500,000.) On March 29, 1991, the Chancellor of the Exchequer introduced a budget that (1) reduces the 35 percent corporate rate to 34 percent retroactive for profits earned in financial year 1990, and to 33 percent for profits earned in 1991, and (2) raises the ceiling on the 25 percent rate to £250,000.

The individual rate is 25 percent for income up to £20,700 and 40 percent for income over this level.

Capital gains are taxed at the same rate as ordinary income. In calculating the amount of gain on disposition of a capital asset, the basis in the asset is indexed for inflation. In addition, individuals are eligible for an annual capital gains exclusion of £5,000, also indexed for inflation.

Treatment of Preference Income

As discussed above, the ACT generally prevents corporate preferences from being extended to shareholders (preference income is taxed at shareholder rates when distributed). However, crediting ACT against mainstream tax has the effect of treating distributions as made first from taxable income.

The U.K. system provides corporations with a variety of tax preferences. The most significant is accelerated capital allowances or "writing down" allowances (equivalent to accelerated depreciation or amortization). To provide investment incentives, accelerated cost recovery is allowed for certain types of capital expenditures. Generally, all investments in business machinery and equipment are "pooled," i.e., treated as a mass asset. In lieu of depreciation, taxpayers are permitted to recover 25 percent of the pool each year, on a declining balance basis. Scientific research expenditures and certain oil exploration costs in the U.K. can be fully deducted in the year incurred even if they create an asset. Capital expenditures on industrial and commercial buildings in enterprise zones are deductible in full when incurred. Additional preferences are available for mineral extraction operations, industrial buildings, and patents and know-how.

Treatment of Domestic Intercorporate Dividends

A U.K. corporation paying a qualifying distribution to another U.K. corporation generally must pay ACT on the distribution, but the recipient corporation is exempt from tax on the distribution. A U.K. corporation receiving a dividend generally cannot claim a refund or credit of ACT paid on that dividend. However, the recipient corporation can redistribute a dividend that has been subject to ACT (franked investment income) without incurring further ACT, and its shareholders are entitled to a credit for the ACT paid by the original distributing company. The effect of imposing ACT on intercorporate dividends is to recapture preferences prior to distribution of preference income out of corporate solution.

If a recipient corporation receives more franked investment income than it distributes, it can carry forward the excess franked investment income indefinitely. Alternatively, the recipient corporation may claim a refund of ACT paid on the excess franked investment income by offsetting the excess against any losses for the year. If, in a subsequent year, payments by the corporation of franked investment income exceed receipts of franked investment income, any refund of ACT received in the earlier year is recaptured.

Qualifying distributions between U.K. corporations are not subject to ACT if a group dividend election has been made. Such an election may be made with respect to dividends from a more than 50 percent owned subsidiary. If a group dividend election is made, the distribution is not treated as franked investment income and thus is subject to ACT when redistributed.

Treatment of Foreign Source Income

U.K. corporations are taxed on their worldwide income, with relief from double taxation provided through a foreign tax credit system. U.K. corporations are allowed a credit for foreign taxes paid subject to the following limits.[33] First, the foreign tax credit is allowed only against U.K. tax payable on foreign source income from the particular source with respect to which the foreign tax was paid. Second, unused foreign tax credits may not be carried forward or back.

Foreign tax credits cannot be used to satisfy liability for ACT where qualifying distributions are paid out of foreign source income. Thus, the benefit of the foreign tax credit is washed out with respect to distributed foreign source income.

The amount of ACT that may be applied against mainstream tax imposed on foreign source income effectively is the lesser of (1) the mainstream tax on foreign source income and (2) 25 percent of foreign source taxable income. The effect is that foreign tax credits are allowed before the ACT and ACT that is unused because of foreign tax credits is carried back or forward. This ordering rule favors taxpayers because surplus ACT, unlike surplus foreign tax credits, can be carried forward.[34]

Treatment of Tax-Exempt Shareholders

A tax-exempt shareholder is entitled to a refund of the shareholder credit. The primary entities exempt from tax on investment income are charities, pension plans (called "exempt approved schemes"), and building societies.

Treatment of Foreign Shareholders

The treatment of dividends paid by U.K. corporations to foreign shareholders varies depending on whether they are entitled to treaty benefits. Except as provided by treaty, only shareholders that are U.K. residents are entitled to imputation credits on dividends received from U.K. corporations. On the receipt of such dividends, a foreign shareholder not entitled to treaty benefits is treated as having income equal only to the amount of the distribution (rather than the distribution plus the imputation credit), the rate of tax applicable is the same as for residents (25 or 40 percent for individuals), the foreign shareholder is treated as having paid tax at the 25 percent rate on the distribution, and the foreign shareholder generally is not entitled to the imputation credit.

Under tax treaties, foreign shareholders generally are entitled to some or all of the imputation credits otherwise allowable to resident shareholders with respect to a dividend from a U.K. corporation, and the rate of tax is reduced (the amount of the reduction may vary depending on whether the shareholder is a portfolio or nonportfolio investor). For example, for a U.S. shareholder owning less than 10 percent of the stock of the distributing corporation, the U.S. treaty entitles the shareholder to the full imputation credit and reduces the tax to 15 percent of the amount of the dividend grossed up for the credit (imposed as a withholding tax). For a U.S. shareholder owning at least 10 percent, the shareholder is entitled to one-half of the imputation credit and the rate of tax is reduced to 5 percent of the dividend grossed up for the amount of the credit allowed (also imposed as a withholding tax).[35]

Streaming

The U.K. system contains several anti-streaming provisions. For example, tax-exempt shareholders purchasing at least 10 percent of a corporation are subject to tax at a 10 percent rate on dividends made out of pre-acquisition earnings (but may use attached credits to offset the tax). Restrictions on entitlement to imputation credits apply where there is an arrangement to channel credits to shareholders of a close investment holding company.

In addition, the United Kingdom has adopted measures to prevent trafficking in excess ACT. The principal limitation is triggered where, following a major change in share ownership (a more than 50 percent increase by one or more 5 percent shareholders over a 3 year period), there is a major change in nature or conduct of the corporation's business or a considerable revival of business that had been negligible prior to the ownership change. In such a case, pre-change surplus ACT cannot be used to offset post-change mainstream tax.

Treatment of Interest

Interest paid by U.K. corporations generally is deductible if the indebtedness is incurred for business purposes. Interest received by a resident lender generally is includable in the lender's income. Foreign lenders are taxed on U.K. source interest at the same rate as residents, but this tax may be reduced or eliminated under treaties. For example, U.K. source interest received by a U.S. resident is exempt from U.K. tax under the U.S. treaty.

APPENDIX C: EQUIVALENCE OF DISTRIBUTION-RELATED INTEGRATION SYSTEMS

The dividend exclusion, imputation credit and dividend deduction systems produce equivalent results if corporate and shareholder tax rates are the same, all shareholders are taxable, and no corporate tax preferences exist. This appendix illustrates that equivalence and shows how the three systems diverge when each of these assumptions is relaxed.

C.1 EQUIVALENCE OF SYSTEMS IF TAX RATES WERE EQUAL

Table C.1 illustrates the equivalence of the three different types of systems when individual and corporate tax rates are equal (34 percent in the example), all shareholders are subject to tax, and no corporate tax preferences exist. For simplicity, all examples assume that corporations distribute all income when earned.

It might appear counterintuitive that the dividend deduction and imputation credit systems lead to exactly the same result. Nevertheless, from an economic perspective, the two systems are equivalent under these assumptions. This equivalence depends on the assumption that shareholders are indifferent between receiving a certain amount of money as a cash dividend or the same amount split between a cash dividend and a tax credit. Under either the dividend deduction or the imputation credit system, the shareholder has the same after-tax income and pays the same amount of tax. Thus, the corporation's behavior should be the same economically under both systems. To achieve equivalence under the three systems, in the example above, the corporation must adjust its cash dividends to leave its shareholders in identical after-tax positions. This assumption probably better reflects long-term than short-term behavioral responses to the various integration mechanisms.

C.2 EFFECTS OF RATE DIFFERENCES, PREFERENCE INCOME, AND EXEMPT SHAREHOLDERS

Rate Differences

If corporate and shareholder tax rates differ, the three systems no longer produce equivalent results. A dividend exclusion system eliminates whatever shareholder level tax would otherwise be imposed. A dividend deduction system eliminates the corporate level tax and retains the shareholder level tax.

Table C.1
Equivalence of Distribution-Related Integration Systems

	Classical System	Dividend Exclusion	Dividend Deduction	Imputation Credit
Corporate income	100	100	100	100
Distribution	66	66	100	66
Corporate tax	34	34	0	34
Shareholder credit	0	0	0	34
Cash received	66	66	100	66
Shareholder income	66	0	100	100
Shareholder tax[1]	22	0	34	0
Total tax paid	56	34	34	34

[1]Tax due after credits, if any.

An imputation credit system can be structured to tax distributed earnings at either the corporate or individual rate. To tax distributions at the individual rate, a credit would be allowed to shareholders for the full amount of corporate tax paid with respect to a distribution. This credit would be allowable against tax on other income, or, if there were no such tax, fully refundable. To tax distributions at the corporate rate, a credit would be allowed only for tax at the shareholder rate on the sum of the cash distribution and the credit ($95.65 in the second to last column in the example below).[1]

Table C.2 assumes a shareholder rate of 31 percent and a corporate rate of 34 percent.

Preference Income

If some corporate income is not taxed, or is taxed at a lower rate, the alternative systems also do not produce equivalent results. Without modification of the sort described in Section 2.B, a dividend exclusion would automatically extend corporate tax preferences to shareholders, because preference income would not be taxed (or would be taxed at a lower rate) at the corporate level and, with an exclusion for all dividends received, would not be taxed at the shareholder level. A dividend deduction system would not extend preferences to shareholders because shareholders would include dividends in income.

An imputation credit system can be designed to achieve either result. If, as this Report recommends, the policy choice is not to extend preferences to shareholders, a system can be designed to limit the shareholder credit to the corporate tax actually paid with respect to the distribution. If the policy choice is to extend preferences, where corporate and shareholder rates are equal, the system could determine the shareholder credit as though the corporation had paid tax at the full rate on all income, i.e., by grossing up the cash distribution at the full corporate rate.[2] Passing through preferences where there are rate differences is somewhat more difficult.[3]

To illustrate the effects of preferences, holding tax rates equal, Table C.3 assumes that the corporate rate and the shareholder rate are both 34 percent.

Tax-Exempt and Foreign Shareholders

If certain shareholders are wholly or partially exempt from U.S. tax, the alternative distribution-related integrated systems do not produce equivalent results, even if corporate preferences are not taken into account. A dividend exclusion system replicates the current treatment of tax-exempt shareholders, because corporate income is taxed at the corporate level, and a tax-exempt shareholder would receive no additional benefit from a shareholder level exclusion.[4] In contrast, a dividend deduction system produces an absolute benefit to tax-exempt shareholders because corporations could reduce or eliminate the corporate level tax that applies to income from equity

Table C.2
Effect of Rate Differences

	Classical System	Dividend Exclusion	Dividend Deduction	Imputation Credit	
				At Shareholder Rate	At Corporate Rate
Corporate income	100	100	100	100	100
Distribution	66	66	100	66	66
Corporate tax	34	34	0	34	34
Shareholder credit	0	0	0	29.65	34
Cash received	66	66	100	66	66
Shareholder income	66	0	100	95.65	100
Shareholder tax[1]	20.46	0	31	0	0
Total tax paid	54.46	34	31	34	31[2]

[1]Tax due after credits, if any.
[2]The shareholder would have an excess credit of $3 that would be refunded or could be used to offset other tax liability.

Table C.3
Effect of Preferences

	Classical System	Dividend Exclusion	Dividend Deduction	Imputation Credit: Preferences Passed Through	Imputation Credit: Preferences Not Passed Through
Corporate income	100	100	100	100	100
Preference income	40	40	40	40	40
Taxable income	60	60	0	60	60
Distribution	79.6[1]	79.6[1]	100	79.6[1]	79.6[1]
Corporate tax	20.4	20.4	0	20.4	20.4
Shareholder credit	0	0	0	41	20.4
Cash received	79.6	79.6	100	79.6	79.6
Shareholder income	79.6	0	100	120.6	100
Shareholder tax[2]	27.06	0	34	0	13.6
Total tax paid	47.46	20.4	34	20.4	34

[1]This is the maximum amount the corporation can distribute after payment of the corporate level tax.
[2]Tax due after credits, if any.

supplied by tax-exempt shareholders by deducting payments of dividends to tax-exempt shareholders. A dividend deduction system also would maintain the same benefit relative to taxable investors that tax-exempt shareholders enjoy under current law.

An imputation credit system with full refundability would have the same effect as a dividend deduction system. An imputation credit system that does not permit credits to be refunded to tax-exempt shareholders would have the same effect as a dividend exclusion system.

Table C.4 assumes that all shareholders are fully exempt from tax and that the corporation pays tax on all of its income at a 34 percent rate.

The treatment of foreign shareholders under each system is similar. A dividend deduction system would extend automatically the benefits of

Table C.4
Effect of Tax-Exempt Shareholders

Effect of Tax-Exempt Shareholders

	Classical System	Dividend Exclusion	Dividend Deduction[1]	Imputation Credit: Refundable	Imputation Credit: Not Refundable
Corporate income	100	100	100	100	100
Distribution	66	66	100	66	66
Corporate tax	34	34	0	34	34
Shareholder credit	0	0	0	34	34
Cash received	66	66	100	66	66
Shareholder income	66	0	100	100	100
Shareholder tax[2]	0	0	0	0[3]	0
Total tax paid	34	34	0	0	34

[1]No withholding on dividends. (A dividend deduction system with a nonrefundable "withholding" tax of 34 percent would duplicate the results under a dividend exclusion system or an imputation credit system with nonrefundable credits.)
[2]Tax due after credits, if any.
[3]The tax-exempt shareholder would receive a $34 refund.

integration to foreign shareholders, because only one level of tax (the current withholding tax on dividends) would be collected on corporate income distributed to foreign shareholders. A dividend exclusion system would automatically deny the benefits of integration to foreign shareholders (assuming, again, that the current withholding tax remains in place). In contrast, an imputation credit system would extend benefits to foreign shareholders if the imputation credit is refundable and would deny benefits if the credit is not refundable to foreign shareholders.